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Year-End Tax Planning for Contractors: What To Do Before It's Too Late!

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As the year winds to an end, it is time again to consider steps contractors can take to reduce their upcoming tax burden. The tax code offers construction contractors many unique considerations. Contractors and their bond producers can use the process outlined below to help reduce the contractor's tax liabilities.

Where Is the Contractor Today?

The planning process should begin by calculating net income from year-to-date operations. Any potential changes that could impact the contractor's financial results should be considered, including items that are uncertain and subject to potential adjustment, as these will impact the results as the contractor continues to plan. One way to do this is to look at documentation from the prior year and see what adjustments were made at year-end. For example, due to advantageous expensing opportunities, capital expenditures, disposals, or depreciation could cause significant adjustments. They should check contract cost estimates and allocations for any pending adjustments to contracts that may be trending better or worse than projected.

Anything from Last Year that We Need to Know?

Reserves, allowances, and other non-deductible accruals and deferrals related to contract or accounting methods from the prior year often impact the results of operations. Other potential deductions that can arise from the prior year's return include net operating losses, disallowed contributions, AMT credit carryforwards, and similar deductions. When reviewing the current and prior year, contractors should also perform look-back and gain-fade analyses. The look-back analysis is an "as if" recalculation of a contractor's taxable income based on the actual performance of completed jobs. There can be tax consequences in the form of taxable income and related interest for contracts that perform significantly better than originally estimated.

What's Going to Happen?

Once the year-to-date operations have been updated and are considered reliable, the contractor should think about any factors that are going to impact the remainder of the year. This could include projects the contractor is bidding on and anticipating to start, contracts that might be completed by year-end, purchases the contractor is considering, and any other significant factors they might be aware of. They should utilize this information to make a projection for the rest of the year. Are the remaining months going to be better, worse, or the same as last year? They should consider prior year projections, the current year’s budget to actual results, budgets on recently completed contracts, and any forecasts for the current year.

Is Washington Going to Have a Say?

Every U.S. Presidential Administration wants to add its own pieces to the puzzle as it reacts to the changes in our society and economy. As we all know, the COVID-19 pandemic and related impact on the nation’s economy led to a number of recent changes, including the passage of the CARES Act in 2020 and the introduction of the American Rescue Plan Act in 2021. Last year’s Paycheck Protection Program (PPP) created a once-in-a-lifetime opportunity; proper accounting for PPP proceeds is essential. For federal purposes, proceeds are not taxable and expenses are deductible (while still increasing basis). Some states are not following federal guidelines; so contractors should review the contractor's states' rules and plan accordingly.

It is imperative to consider any recent, pending, or potential changes in tax laws that may impact the current year’s tax plan. There is recently proposed pending legislation that, if enacted, will have wide-ranging impacts. A few highlights from the outstanding proposal:

- Corporations might see a return to graduated tax brackets ranging 18% to 26.5% (a change from the current flat rate of 21%).
- Similarly, the tax rates for individuals earning more than $450,000 might be increased (in tax years that begin after January 1, 2022) from 37% to 39.6%.
- In addition, certain taxpayers with earnings in excess of $5 million (or $2.5 million if married filing separately) may be subjected to an additional 3% surcharge on the earnings.
- There are possible limits to the 20% qualified business deduction.
- Changes to capital gains and other rates, as well as numerous changes to deductions and limitations, are also included in the proposal.

Tax Methods Are Different than Book Methods!

The tax code provides taxpayers who perform work on long-term contracts multiple tax methods to optimize their tax position that depend on the size of the contractor and the nature of the underlying work. In general, long-term contracts must be accounted for under the “percentage of completion” method. However, there are a number of nuances within the code. Smaller contractors— those companies with average gross receipts from the three previous years of less than $26 million—have additional options, as do contractors working with residential and home construction contracts. Contractors should review these factors for any changes in their contract volume and mix. Certain changes in accounting elections are automatic, while others will require IRS approval. If the contractor identifies a change in accounting methods that would be beneficial or is required, and that is subject to IRS approval, they should apply before the close of the fiscal year. The IRS allows contractors to use multiple methods to optimize their tax advantages.

What Should The Contractor Try?

Maximizing the benefits of tax deferrals and credits can yield substantial savings. Here are some of the more common credits:

- Employee retention credits
- Research and development

- Energy credits and deductions
- Section 179d “green” governmental structures
- Work opportunity credits
- Certain investment credits

Tax deferrals can be generated by carefully timing certain transactions, such as accruing or paying expenses prior to year-end or capitalizing certain costs associated with future contract completion. The contractor should ensure that it properly accounts for contract progress. Additional credits and deferrals are available under the rules enacted following the COVID-19 pandemic. Contractors should be aware of the opportunities that are available.

Who’s Going to Be Paying These Taxes?

The ultimate goal of tax planning is to minimize the impact to the owners of the company. Tax planning should ensure a proper balance between entities and owners. If there are related entities or multiple owners, careful consideration should be made to utilize the lowest tax brackets possible in the mix of entities and ownership. Contractors have many transactional tools available to achieve optimal allocation between the contractor, its owner, and any related parties. These tools can include structuring salaries, guaranteed payments, management fees, rental agreements, owner financing, and many more. It is important to factor in the impact of alternative minimum tax items that flow through to the owners from the strategic use of deferrals, deductions, and credits. Once the contractor estimates the tax impact on the owners, ensure that proper withholdings and estimated payments are made to avoid unnecessary penalties and interest charges.

Who Does What and When?

The final stage of good tax planning is making a detailed list of priorities and objectives to achieve before the end of the fiscal year and the filing deadlines, as applicable. Contractors should carefully review cost allocation on jobs finishing with higher margins than expected. They should review percentage of completion for tax purposes to ensure accurate reporting of job gross profit. They should ensure that all planned bonuses to the owners, management, and others are made in the appropriate time frame with the appropriate withholdings to avoid penalties or disallowance of a deduction. If the contractor identifies a need for capital equipment to maximize depreciation deductions, they need to verify that the transactions are completed as planned.

We’re In This Together!

Proper utilization of tax planning strategies can yield substantial savings for contractors of all sizes. Collaboration is a critical part of all the processes listed above, as pertinent information is housed in both internal and external components of the business environment. Contractors should communicate with professionals dedicated to working with the construction industry. They should have a meeting--before it’s too late!

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